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UNCLAS SECTION 01 OF 04 BRASILIA 000040

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SUBJECT: FIRST TEST OF BRAZIL'S NEW ENERGY REGULATORY MODEL
GENERATES CONCERN

REFS: A) 04 BRASILIA 2834 NOTAL

B) 04 RIO DE JANEIRO 518

C) 04 SAO PAULO 591

1. (U) This cable reflects input from Consulates General
Sao Paulo and Rio de Janeiro.

2. (SBU) SUMMARY. The GoB took a long-awaited first step towards implementing its new energy regulatory model with a December 7 auction of electricity supply futures. The Ministry of Mines and Energy (MME) trumpeted the auction as an unqualified success, but analysts, investors and regulators have criticized both the conduct and results of the auction, which resulted in unexpectedly low energy prices. While some observers see the results simply as a function of current excess supply and other market factors, many analysts are concerned that the low prices will decapitalize existing power producers and fail to generate sufficient investments to match future energy needs. Although the auction was the first real test of the GoB's new energy regime (reftels), additional auctions to be held in early 2005 should more clearly indicate the new model's fate. END SUMMARY.

BACKGROUND: FINALLY A NEW ENERGY MODEL

3. (U) Since 1995, GoB energy policy has acknowledged the need for reliance, to some degree, on market forces and private sector involvement, including some privatization of the sector. Upon taking office in 2002, however, the Lula administration was determined to establish a new model for the sector (reftels). While the Lula administration did not want to pursue further privatization of existing power companies, which are primarily parastatal, it recognized that it still needed to bring in new private investment into the sector. The result was a new hybrid model, enacted in March 2004, designed to stabilize the energy sector by increasing state control while maintaining aspects of market competition.

4. (U) To account for the differences in cost structures among older, already-amortized power plants and new investment, the complicated new model divides power generators into two competition groups: "old energy" (generators that came on-line before January 1, 2000) and "new energy" (future generators and those that came on-line after January 1, 2000). (Note: existing generators whose projects came on-line after the cut-off date for "old energy" are sometimes referred to as "Energia de Botox" - i.e., old energy, but with a new face. End Note.)

THE FIRST TEST OF THE NEW MODEL

5. (U) The December 7 "old energy mega-auction," run by the newly-created Electrical Energy Commercialization Chamber (CCEE), was widely seen as the first real test of the new GoB energy model. The 17,000-megawatt auction was for the "captive" consumers -- primarily households and small businesses -- who represent a little over 60% of current power demand, and who purchase energy through the large distributors. (Note: Large industrial and commercial power consumers may negotiate power-supply contracts directly with the energy producers, including some private companies who did not sell their energy at the auction, through the Free Contract Market (ACL). End Note.)

6. (U) Brazilian Minister of Mines and Energy Dilma Rousseff publicly called the auction a "success," and declared it would bring stability to the energy sector through longer-term contracts and lower consumer prices. The national average price for energy at the time of the auction was R\$61/MWh. For the 8-year contracts auctioned, the average results were as follows:

Year	Price	%-of-Demand Contracted
2005	R\$57.51/MWh	98.9%
2006	R\$67.33/MWh	91.7%
2007	R\$75.46/MWh	100%

17. (U) Although there is currently a surplus of energy -- in part because recent rains have replenished the country's hydro reservoirs -- the auction resulted in even lower prices than either analysts or the GoB expected. Investors and analysts responded negatively immediately after the auction and stock prices for many energy companies plunged; in the three days after the auction, the stock of Eletrobras (a parastatal and also the country's largest electricity generator) fell 21.5% and the electric power index on the Bovespa stock exchange fell 7.9%. Many analysts expressed concern that the prices were too low for the state-owned companies to invest in future generating capacity and that the low prices would not attract private sector investment. Other analysts believe, however, that the Bovespa's quick return to pre-auction levels indicates that the market initially over-reacted to the results. They note that the prices were still substantially higher than the current spot price (Reais 18.59), and that, when adjusted for inflation, 2007 prices approach the lower bounds of the system's marginal cost of expansion (at current exchange rates).

TWEAKING THE AUCTION RULES

18. (SBU) One of the Directors of ANEEL (the Brazilian Electricity Regulatory Agency), Isaac Averbuch, told Brasilia EconOff the low prices were the result of GoB rules for the auction. Averbuch does not consider it to have been a true auction since the rules created a "permanent imbalance" between supply offered by generators and demand. Indeed, by separating the auction of "old energy" from "new energy", the initial auction benefited the primarily state-owned companies whose debts were amortized and could thus offer lower prices.

19. (U) The state-owned companies also did not face the same pressure as private companies in terms of bottom-lines and investment returns. During the auction itself, 6 of the 18 participating producers reportedly dropped out after the first round of bids. We are not aware of any state-owned companies that withdrew from the pool even as the prices continued to drop. To the contrary, Eletrobras subsidiaries were reportedly responsible for 65% of the energy auctioned. Although the GoB plays a central role in the auction, the distributors ultimately sign contracts directly with the generators.

110. (SBU) During the auction, when the prices dropped below a certain level, the energy companies participating could withdraw their energy offer from the auction. Under more traditional rules, supply would have been below demand, forcing the price to rise again until enough power was offered to meet the demand. However, the GoB created a mechanism that allowed it to keep forcing prices down. According to Averbuch, the GoB could adjust the demand to keep demand less than the supply so that prices would continue to drop. The energy demand removed from the auction would then be met with power sold on the spot market rather than the long-term contract auction.

PRIVATE SECTOR PERSPECTIVE

11. (SBU) U.S.-owned energy firms Duke Energy and AES told Sao Paulo EconOff they believe the GoB conducted the auction in a manner that favored state-owned generators and distributors. Duke Energy Director for Regulatory Affairs Paulo Born lends support to Averbuch's assertion of GoB manipulation of the auction rules. Born said that, in the second phase of the auction, the GoB lowered forecasted demand while state-owned generating firms offered a consistent supply. This resulted in a downward pressure on bid prices that private companies found difficult to match. (Note: Although it is not clear how much of the energy demand was removed from the auction through this method, many companies withdrew their energy supplies from the auction as the prices dropped and not all of the demand was met for contracts beginning in 2005 and 2006. End Note.) Born described the auction as a GoB play for political advantage and "popular support" by holding energy prices down. AES Vice President for Business Development Ricardo Lima told us that, although the auction resulted in lower than anticipated prices, the outlook for energy distributors has improved, citing guarantees provided for distribution companies under the new energy model. He said the prospects for energy generation firms were still worrisome, and that it will likely be several years before the country will be able to attract new investment.

SHORT-TERM VS. MID-TERM PROGNOSIS

12. (SBU) The Minister of Mines and Energy has publicly stated that the auction results will mean lower prices for the consumer. Many reporters have repeated the same prediction, at least for the short-term. Lima from AES predicts that prices may drop 2.5%. Averbuch, however, says the prices will probably not go down so much as they may just not rise as quickly.

13. (SBU) Averbuch, Born, Lima and other energy analysts predict that Brazil faces a possible shortage of energy in the short-term (2008-2009) similar to the crisis the country suffered in 2001. This may be the case given the approximately 4 years a new hydroelectric plant -- the GoB's preferred type of power plant -- takes to progress from concession to operation, especially if a future drought leads to water shortages at the main reservoirs. The GoB did not solicit bids for the construction of new power plants during 2003 and 2004, and the press reports that of the 45 hydroelectric plant concessions auctioned between 1997 - 2002, only 21 have begun construction. Many projects are delayed because of environmental licensing problems. While a new thermal power plant can be built in 2 to 3 years, the GoB policy views thermal power primarily as emergency back-up.

14. (SBU) In the medium-term (2010-2012), however, Averbuch predicts precisely the opposite problem, because in the new model the GoB has reserved for itself the role of predicting how much new generation capacity is needed. These predictions will be made by a newly formed and purportedly independent Energy Research Enterprise (EPE). The GoB plans to auction concessions for new power plants to supply energy based on the EPE energy consumption projections. Averbuch fears that because the GoB will likely over-estimate the energy needs based on overly optimistic economic growth projections, Brazil may have an energy surplus by 2010 that will lead to a ballooning bill for contracted energy.

UPCOMING "NEW ENERGY" AUCTION

15. (U) Although there is considerable concern over the results of the December auction, investors are watching the upcoming auction of "new energy" even more closely. The "new energy" auction is expected in March or April for contracts beginning in 2008 and 2009, and the GoB will conduct up to four additional auctions during 2005 for contracts to supply estimated new future demand. Wary of the timeframe to bring new generation capacity on-line, in the new auction the GoB will only solicit bids from companies with already-approved environmental licenses. However, according to news sources, even among companies with approved licenses, such as Tractebel, the decision whether to construct the new plants is pending the results of the next auction.

COMMENT

16. (SBU) While the results of the December "old energy" auction were less than encouraging, existing generators had little option but to minimize their losses and make their peace with the new model. Beyond the lower than expected prices, of perhaps greater concern is the apparent GoB manipulation of the auction rules and the influence of the large, state-owned energy producers. That said, the outlook for private investment hinges more on the results of the "new energy" auction, which should show starkly how much confidence private investors have in the new model.

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